STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	:	
	:	
Petition for approval of delivery services tariffs and tariff revisions and of residential delivery services implementation plan, and for approval of certain other amendments and additions to its rates, terms, and conditions.	: : : : :	No. 01-0423

Phase II Rebuttal Testimony of

KARL A. MCDERMOTT, PH.D.

Vice President,
National Economic Research Associates, Inc.

I. **Background**

Q. Please state your name.

A. My name is Karl A. McDermott.

Q. Are you the same Karl A. McDermott who presented direct testimony in Phase II of this docket?

A. Yes, I am.

Q. What is the purpose of your Phase II rebuttal testimony?

A. The purpose of my Phase II rebuttal testimony is to present my comments and analysis of the Phase II direct testimony of intervenors in this docket, especially the testimony of Government and Consumers ("GC") witness Mr. David Effron (GC Exhibit 7.0).

Q. What are your conclusions concerning Mr. Effron's testimony?

A. While generally supporting the adjustments proposed by the Liberty Consulting Group ("Liberty") in its October 4, 2002 audit report (the "Liberty Report"), Mr. Effron presents a series of modifications or alternative methodologies that he suggests could be applied to the Liberty Report. However, there is nothing in Mr. Effron's testimony that can rehabilitate the Liberty Report, in view of the numerous conceptual and practical deficiencies that were set forth in my Phase II direct testimony (ComEd Exhibit 102.0). I conclude that Mr. Effron's testimony points out the very problems that I previously addressed in my direct testimony — in particular, that the Liberty Report's "global" operations and maintenance ("O&M") trend-line and capital additions adjustments are subjective and can be manipulated to provide arbitrary outcomes that are more favorable to the analyst's predisposition.

Q. How is your testimony organized?

A. **Section II** presents my rebuttal of Mr. Effron's attempts to use, with adjustments, the Liberty Report's O&M trend-line results. **Section III** presents my rebuttal of Mr. Effron's attempts to defend the Liberty Report's "normalization" of ComEd's timing of rate base additions.

II. Mr. Effron Provides a Clear Illustration of the Subjectivity Inherent in the Liberty Report

Q. Please discuss Mr. Effron's comments on the use of 1991 as the base year for calculating Liberty's global normalization adjustment.

A. In my Phase II direct testimony (at pages 15-16), I was concerned that Liberty's proposed global trend line for O&M expenses was subject to manipulation based on the predisposition of the analyst. I further explained (at page 23) that "[t]he mere variation of costs above an arbitrarily created trend line is simply not evidence that those incremental costs are unreasonable."[1] Given the problems with the Liberty Report, the Commission should reject Liberty's global O&M trend-line analysis, as well as Mr. Effron's "alternatives." Mere allegations of "abnormality" of cost levels are insufficient to show imprudence.

Mr. Effron has provided an excellent example of the problems with the Liberty Report in practice. For example, Mr. Effron suggests that the 1991 base year was reasonable: "[a]s 1991 was prior to the reductions in O&M experienced in the mid-1990's, it is reasonable to use 1991 as a base year for calculating a normalized level of

[1] Mr. Effron appears to suggest that *any* variation of costs from the trend line is *per se* imprudent. (GC Exhibit 7.0 at pages 3-6). Such logic simply does not hold, as variations in costs can be a result of perfectly prudent behavior, such as utility responses to increased customer expectations. The Illinois Commerce Commission (the "Commission") should disregard Mr. Effron's attempts at redefining the prudence standard.

O&M expense."[2] Mr. Effron's predisposition comes out clearly in the next statement, where he notes, "[i]n fact, the use of 1991 as a base year again appears to be quite conservative."[3] By "conservative" Mr. Effron simply means that choosing 1991, as opposed to 1992, 1993, 1989 or even 1990, produces a global "normalized" O&M expense that is greater than would have been the case if those other years had been used. That is, Mr. Effron is not using the term "conservative" to refer to actual costs, but rather is referring to the relative results of varying the methodology used by Liberty. Not surprisingly, Mr. Effron goes on to suggest (at page 13) to "avoid potential distortions from the use of a one-year period as the base," a three-year average could have been used. This produces a global "normalized" O&M for 2000 that is lower than Liberty's proposed amount by $6.4 million.

Q. Does Mr. Effron support this even lower "normalized" level of O&M?

A. No. Ironically, even through Mr. Effron suggests that a 1991 base year would create "distortions" in the final figures, he is not proposing to adjust the analysis, because "on balance" he believes the Liberty Report to be reasonable.[4]

Q. How does Mr. Effron's discussion illustrate the subjective nature of the Liberty Report?

A. From Mr. Effron's statements, it is crystal clear that the analysis provided by Liberty bears no relationship to the actual O&M expense portion of the revenue requirement that ComEd needs to operate its system. Mr. Effron does not even attempt to place the

---

[2] GC Exhibit 7.0 at page 12.

[3] *Id*.

[4] *Id*. at page 15. Mr. Effron does propose that the Commission accept some of his proposals, resulting in a reduction to ComEd's revenue requirement of nearly $50 million *less* than the reduction proposed by the Liberty Report. *Id*. at page 26.

analysis in the context of Commission precedent; neither does he support it with facts concerning ComEd's actual O&M expenses. Rather, he simply points out that if the Commission were so inclined, it could reduce ComEd's allowable O&M expenses by even more than Liberty proposes by playing around with the beginning dates of the analysis (as well as other items). It is unclear why Mr. Effron would point out flaws in the Liberty analysis, while not proposing to implement "solutions" to those flaws. One can only conclude that the subjective nature of the Liberty analysis, as Mr. Effron's testimony so clearly illustrates, lends itself to manipulation, but because Mr. Effron is pleased with the outcome "on balance," he supports the use of the flawed method. Such an analysis cannot be supported by fact and should not be used by the Commission to adjust ComEd's revenue requirement.

Q. Mr. Effron also discusses his view of the scope of audit authorized in Docket No. 01-0664, and what it means for an expense to have been found to result from "remedial activities" engaged in by ComEd. Has there been any Commission determination in Docket No. 01-0664, in the April 1, 2002 Interim Order in this proceeding (the "Interim Order"), or otherwise that you are aware of, that the expenses of all "remedial activities" are to be disallowed?

A. No. And, to my knowledge, the Commission has not made even the presumption that Mr. Effron makes: that all "remedial activities" are *per se* imprudent or atypical, and should be disallowed. Simply because an expense (or a rate base item) has been determined to be part of a "remedial activity" does not imply, in and of itself, imprudence or a disallowance of recovery. For the Commission to disallow any cost or investment, it must be convinced that the cost or investment was made improperly or inefficiently as a result of an unreasonable act of ComEd management given the information then available to ComEd and that the cost or investment caused customers to pay higher net rates. Simply because a utility responds to an outage or to a more demanding customer and regulatory environment does not create the presumption of imprudence. Nor does the argument that investments or O&M spending that all now admit to be appropriate should have been made earlier make such investments or spending subject to disallowance. I note that this mistaken presumption also makes the Staff proposal inappropriate.

Q. Please describe other areas of Mr. Effron's testimony that indicate the subjective nature of the Liberty analysis.

A. First, Mr. Effron suggests that "it would not be unreasonable to offset the compound escalation factor based on inflation and customer growth by a productivity factor."[5] He even goes so far as to illustrate the effect of this offset proposal using a 0.5% adjustment factor that Mr. Effron suggests is consistent with his "experience." Mr. Effron provides no support for this adjustment. Moreover, Mr. Effron is highlighting the inherent subjectivity of a global trend-line analysis by providing illustrations of how that trend line can be manipulated to produce lower (or one could also imagine higher) "normal" expenses. Productivity adjustments in price-cap contexts are set to adjust a measure of overall inflation (*e.g.*, GDP-PI) by a measure of expected productivity improvements, given that the utility will have incentives to improve its productivity over the forward-looking term of the price-cap plan. As such, the 0.5 percent productivity adjustment

[5] GC Exhibit 7.0 at page 13.

amounts to another arbitrary adjustment to ComEd's costs. The Commission should see this attempt at manipulation for what it is and reject the entire approach.

Second, Mr. Effron discusses several "alternatives" for accounting for the effect of refunctionalization. He illustrates the effect of these alternatives on Liberty's proposed O&M adjustment and finds differences in the O&M outcomes. Again, the implication is that the Commission has a "menu" of alternatives to choose from in adjusting ComEd's revenue requirement. The Commission should see this for what it is and reject this cafeteria approach. (The Phase II rebuttal testimony of ComEd witness Michael Born (ComEd Exhibit 119.0) discusses which alternative ComEd is most accurate.)

Last, Mr. Effron discusses the use of the GDP Implicit Price Deflator as a reasonable check on the escalation of O&M expenses over time (added to customer growth), even though there is little reason to expect O&M escalation to track inflation. Mr. Effron ignores the fact that both the "price" and the "quantity" portions of O&M costs are changing. The GDP Implicit Price Deflator can measure changes in overall prices, but it does not deal with changing quantities. ComEd, for reasons that are well known, has increased its transmission and distribution O&M costs in response to customer demand and changing customer expectations, not to mention the simple expansion of its system. Mr. Effron does not even attempt to place his approach in the context of any fact pattern concerning actual O&M expenses.

Q. Do you have any further comments on Mr. Effron's defense of the global O&M trend-line approach proposed by Liberty with an additional adjustment for productivity?

A. Yes, I do. Mr. Effron's extension of the Liberty methodology suggests that the Commission establish what is tantamount to a backward-looking, retrospective price cap for ComEd's distribution O&M. Liberty's (and Mr. Effron's) approach is an unsound, retrospective misapplication of performance-based regulation, commonly referred to as "RPI-X." In an RPI-X price-cap formula, the price a utility could charge in the future would be escalated from some initial level based on a general inflation level (RPI)[6] minus a productivity factor (X).[7] The theory behind this formula is that the regulated company would have an incentive to pursue cost reductions as its prices would be capped, but profits would not be regulated.

For multiple practical and theoretical reasons, this approach is not appropriate in this case. First, this approach is simply not the way to set cost-based rates based on test-year costs. Second, even if this Docket were about "price caps," Mr. Effron does not propose a forward-looking price-cap plan. A proper price-cap plan would allow prices to change over time with the escalation factor (RPI-X). Nowhere does the Liberty Report or Mr. Effron suggest such a mechanism. Further, an appropriate price-cap plan would allow the utility to retain the cost savings (beyond a normal regulatory lag). Again, nowhere does Mr. Effron or the Liberty Report suggest such a mechanism. Liberty and Mr. Effron have simply chosen the part of the price-cap plan that is favorable to their predisposition. Again, this shows the arbitrary, subjective, and selective nature of the

[6] The inflation factor that Liberty suggests would also allow for cost escalation for customer growth as well. Many price-cap plans include such a factor.

[7] Ironically, it is the general practice to set the initial rates based on a "traditional" rate case, although neither Liberty nor Mr. Effron proposes such a practice. My use of the term "traditional" refers to cost-plus or rate-of-return regulation. Such regulation is based on the costs incurred by the utility to serve customers and is not based on benchmark costs, as Mr. Effron and Liberty are proposing in this case.

analysis. Finally, in Illinois, it is my understanding that a performance-based regulation plan must be pursued under Section 9-244 of the Illinois Public Utilities Act (the "Act") (220 ILCS 5/9-244). It is indisputable that this case was not filed under Section 9-244 and is therefore a "traditional" rate case that must be litigated under the applicable sections of Article IX of the Act.

Q. Are there any other problems with Mr. Effron's proposed productivity adjustment?

A. Yes. Empirically, Mr. Effron simply fails to justify the 0.5% value. It is yet another arbitrary, subjective value.

Q. In proposing his productivity adjustment, does Mr. Effron consider other adjustments that would tend to go the other way?

A. No. For example, although Mr. Effron discusses productivity, he does not even discuss the data Liberty used to attempt to assess what the net effect of productivity is. In this case, Liberty's "peer group" experienced an increase in distribution expenses of about four percent per year during the 1991-2001 period, according to the Liberty Report (at pages II-49 to II-50).[8] Nor does Mr. Effron take into account or comment on Liberty's failure to justify its exclusion of the years 1998-1999 from its average, which would seem to be an example of subjective "data mining" to get the numbers that the analyst wants. Mr. Effron simply subtracts the arbitrary productivity adjustment that he proposes.

Q. Please summarize how Mr. Effron's testimony relates to your criticism of the subjectivity in the Liberty Report.

[8] *See, e.g.,* Liberty's response to ComEd Data Request No. 3.89.

A. In my Phase II direct testimony, I spoke of the need to remove, to the extent possible, the subjective, menu-oriented adjustments from a proper analysis of ComEd's revenue requirement; the mischief that can occur with an approach that allows the "customer" to pick his or her adjustment from the menu of possible adjustments is illustrated well by Mr. Effron. I noted that the methodology employed by Liberty sets the Commission on the path toward "results-oriented" decision-making that is not based on a proper prudence analysis. The problem with subjectivity should be even clearer now as a result of Mr. Effron's testimony and its enumeration of ways in which an analysis like Liberty's can be arbitrarily "tweaked." Fairness requires that any imprudence be demonstrated objectively. Otherwise, one is not measuring prudence; one is simply testing the ability of the analyst to come up with a different answer after the fact.

Moreover, Mr. Effron's testimony illustrates another flaw in the Liberty analysis that I commented on. The "global" trend-line approach presupposes that utility O&M spending can be estimated by a simple percentage to obtain the "correct" amount in any given year. To accept such a method, one must suspend disbelief concerning the physical operation of the system and the actual drivers of spending, including increased customer expectations, and accept the arbitrariness of the selection of the beginning and ending points. Mr. Effron illustrates well how the "correct" result that Liberty's methodology purports to define is dictated by the arbitrary choice of starting points and the decision to ignore facts, other than general escalators, that inevitably affect costs thereafter.

Q. Isn't this simply a case of reasonable analysts disagreeing on the details of a methodology?

A. No. The problem here is far more fundamental than disagreeing about "details." The Liberty trend-line approach is flawed as a result of deviating from the "first principles" of a proper prudence review. Mr. Effron's testimony simply points out the multiple ways in which Liberty's analysis can be manipulated. A proper analysis would postulate a theory of connection between ComEd's actions and the costs incurred. Neither Mr. Effron nor the Liberty Report has postulated such a theory. Rather, they simply claim that such a proper analysis cannot be done, and then substitute a clearly flawed and subjective analysis for such a proper one. Therefore, while I have gone to great lengths to show the subjectivity inherent in Liberty's analysis, it should be irrelevant how reasonable analysts disagree on the details of this methodology, as the methodology itself cannot be trusted to produce objective results.

Q. In your Phase II direct testimony, you note that Liberty's approach would represent a significant change in Commission ratemaking. Does Mr. Effron support his conclusions with reference to past Commission decisions?

A. Not on the prudence standard or the procedure used by Liberty. Mr. Effron does attempt to support Liberty by suggesting that its analysis is consistent with the Commission's directive in the Interim Order.[9] However, the Commission made no finding in that Order that all costs found to be "recovery" costs would, or properly could, be disallowed. Mr. Effron nonetheless claims that given the "circumstances," Liberty's audit was appropriate. I gather from his testimony that Mr. Effron means that a true prudence analysis (*i.e.,* one that would disallow expenses that were excessive due to management

[9] GC Exhibit 7.0 at pages 4-5. It should be noted that Mr. Effon's citations to the Interim Order are far too general to be of any real use in assessing the reasonableness of the Liberty Report.

decision-making that was unreasonable in light of information available at the time) was not feasible, but that the Commission must nevertheless punish ComEd, despite the fact that Liberty's analysis relies on wholly new "alternative methods to quantify an adjustment to remove abnormal and non-recurring expenses from the cost of service."[10] While not entirely clear, the "circumstances" to which Mr. Effron refers appear to be the allegation that ComEd does not have the correct information in order to conduct an appropriate audit. While I understand that ComEd disputes this allegation, the principle of the matter is simple – without connecting the alleged impudent actions of ComEd with the costs of those actions, the Liberty Report fails to meet the standards for a prudence audit and fails to justify the disallowances that it recommends.

Q. You mentioned Mr. Effron's uncritical acceptance of the Liberty assertion that ComEd was unable to provide the appropriate information in order to undertake a proper prudence analysis. Is this rationale a persuasive justification for Liberty's approach?

A. No. First, I would note that Mr. Effron apparently did not reach an independent conclusion concerning the quality of information that ComEd provided to Liberty. He appears to accept Liberty's conclusion as fact without any testing of its validity or veracity.

Second, Liberty is a professional consulting firm that claims to specialize in these types of audits. As Mr. Crumrine notes in his Phase II rebuttal testimony (ComEd Exhibit 116.0), ComEd has provided Liberty with full access to its books and records and has answered numerous data requests concerning those books and records. Nowhere in

[10] *Id*. at page 5.

the Liberty Report is there an allegation that ComEd withheld information or access to its operations people, its accountants, or its executives and managers. Moreover, Liberty already had extensive experience with ComEd and its systems, having conducted two phases of the Commission's initial post-outage audit of ComEd. Liberty commenced that analysis in 1999 and is still in the process of performing follow-up work. I find it difficult to believe that a million-dollar audit by a consultant that already had substantial other experience with ComEd's systems and personnel was unable to unearth the proper information.

Third, in order to accomplish a prudence audit, one would have to have access to planning and construction project management data, and data from the operations side of the business. Such information was available to Liberty and Liberty does not contend otherwise that this information was not available. It is the responsibility of the auditor to establish a reasonable benchmark based on an appropriate prudence analysis that assesses the validity and reasonableness of the utility's actions.

Fourth, from a policy viewpoint, the Commission should not be forced into the undesirable situation of abandoning its precedents on prudence reviews in order to accept an admittedly less than accurate analysis. Mr. Effron suggests that ComEd should not be "allowed to benefit" because it did not track costs in the manner that Liberty (or Mr. Effron) would have preferred. How ComEd tracked particular costs is irrelevant to the reasons that those costs were incurred, or whether they were prudently incurred. What Mr. Effron actually is saying is that ComEd should be punished by having its revenue requirement slashed because it did not track costs in the manner suggested by Liberty. It should be obvious that ComEd should nether be punished because of nor allowed to gain a windfall from such a situation. Rather, a proper prudence review should have been completed in order to treat both customers and ComEd in a fair manner. Since this was not done by Liberty, the Commission should reject the global trend-line approach as a reasonable substitute for the correct analysis.

III. Rate Base Adjustments

Q. How do you respond to Mr. Effron's comments on rate base additions?

A. Mr. Effron seems, in effect, to be trying to give "moral support" to the Liberty Report's rate base adjustments, without taking the trouble to provide credible and usable evidence that the Liberty Report's adjustments are just and reasonable. As such, Mr. Effron's testimony with respect to rate base adjustments adds little, if anything, of value to the record in this proceeding.

While Mr. Effron states that he "cannot attest to the accuracy of all of the rate base adjustments proposed by Liberty,"[11] he does appear to suggest that they are appropriate in "principle." The "principle" that Mr. Effron states is not supportive of the Liberty Report *per se*, but rather simply states that "if the actual costs of plant additions were overstated or if ComEd incurred extra costs because it had to accelerate spending due to under-investment[12] in earlier years, then such costs should be excluded from rate base."[13] The conditional phrases that Mr. Effron uses ("if the actual costs" and "if ComEd") highlight the weakness of his testimony on these issues – Mr. Effron has

[11] GC Exhibit 7.0 at page 21.

[12] Mr. Effron does not address the issue of how we know that there was "under-investment." In the Liberty Report, an artificial benchmark was used to determine the amount of alleged "under-investment." Therefore, the alleged under-investment has not been shown to have occurred in this case using any objective measure of proper investment.

[13] GC Exhibit 7.0 at page 21.

nothing to say that can show that ComEd has been imprudent and that its proposed rate base additions are not just and reasonable. Liberty's efforts to "normalize" ComEd's capital investments (which efforts Mr. Effron attempts to support) are insufficient to show that ComEd's rate base levels are unreasonable.

Further, Professor Kamien and Mr. Jacobs have testified that moving investment to the past does not necessarily lower overall costs. (*See* ComEd Exhibits 105.0 and 106.0). Therefore, allegations of "under-investing" do not necessitate a prudence disallowance.

Q. Does this conclude your Phase II rebuttal testimony in this docket?

A. Yes, it does.